FILE COPY

DEC 26 1930

CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1930

No. 352

V. LOEWERS GAMBRINUS BREWERY CO.,

Petitioner,

against

CHARLES W. ANDERSON, individually and as collector of Internal Revenue of the United States,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR V. LOEWERS GAMBRINUS BREWERY CO., PETITIONER.

ARTHUR B. HYMAN,
KARL D. LOOS,
Attorneys for Petitioner.

PRESS OF FREMONT PAYNE, NEW YORK CITY

CONTENTS.

	PAGE
STATEMENT	1
OPINIONS BELOW	1, 2
JURISDICTION	2
QUESTION PRESENTED	2, 3
Statute Involved	3
Findings Below	3-8
ARGUMENT	
Petitioner was entitled under Section 234 (A7) of the Revenue Act of 1918 to deduct from gross income (for the calendar years 1918 and 1919) a reasonable allowance for exhaustion, including obsolescence, of its brewery buildings and equipment occasioned by the passage of the Eighteenth Amendment and legislation for the enforcement thereof.	8-9
The Court below misinterpreted the decision of this Court in Haberle v. Crystal Springs Brewing Co. and misapplied it, in holding as a matter of law that a brewing company is not entitled to the deduction granted by statute for exhaustion, wear and tear, including obsolescence of its tangible property	9
Haberle v. Crystal Springs Brewing Company distinguished	10

PAGE

The decision of this Court in the Haberle case went no further than to declare that the allowance provided by statute for obsolescence does not apply to the good will of a business destroyed by Prohibition. This Court not only did not consider the deduction in relation to tangible property, but even reserved for future determination the question whether, under certain conditions, an allowance for obsolescence on intangibles might not properly be granted 10-11-12

The purpose of the deduction was to allow the set up of an annual reserve to take care of deterioration in value which could be anticipated with reasonable certainty in addition to the ordinary allowance for physical exhaustion. The Eighteenth Amendment and the Volstead Act resulted in the obsolescence of the tangible assets of every taxpayer engaged in the brewing of beer, ales and porter. This has been recognized by the Government and effect given to it in every regulation of the Treasury Department 12

The Statutory History of the Deduction 13

The changes in the various revenue acts, considered in connection with the regulations and rulings adopted pursuant thereto, make it clear that the intent of Act of 1918 was to grant to all taxpayers, in addition to the deduction for exhaustion, wear and tear, a reasonable allowance to cover deterioration in value of capital assets not encompassed within the ordinary meaning of exhaustion, wear and tear 13-14

PAGE

The theory of the deduction is that it should be sufficient, together with a deduction for normal depreciation, to return the unextinguished cost of the property less its salvage value at the end of the obsolescence period.. 14-16

The obsolescence deduction is merely an addition to or an acceleration of the depreciation deduction 16

The obsolescence period has been fixed by the Bureau of Internal Revenue as beginning January 31st, 1918 and ending January 16th, 1920 17

The allowance awarded by the judgment of the trial court has admittedly been properly spread through the obsolescence period 17

The right to the deduction has been uniformly recognized.—Decisions reviewed 17-20

The taxpayer is entitled to have the asset value of tangible property left whole at the end as it was at the beginning of each taxable year. If this be not done, the allowance for exhaustion, wear and tear and obsolescence has not performed its function, and net income is distorted. This is accomplished by the reserve for exhaustion, wear and tear and obsolescence 20-24

The judgment of the trial court found and measured the loss of asset value during the obsolescence period and the judgment is unassailable upon the facts 24

The judgment of the Circuit Court of Appeals should be reversed, and that of the Trial Court affirmed 24

TABLE OF CASES.

	PAGE
Auditorium Co. v. Commissioner, 5 B. T. A. 163..	19
Clarke v. Haberle Crystal Springs Brewing Co., 280 U. S. 384	2-8-10-17
Mary Dowling, Appeal of, 6 B. T. A. 976	9-17
George Weidemann Brewing Co., 9 B. T. A. 792	9-17-19
J. Christian G. Hupfel, Appeal of, 9 B. T. A. 945	17-20
Konrad Schrier, 9 B. T. A. 497	9
Michigan Lithographing Co., Appeal of, 1 B. T. A. 989	19
Robert H. McCormick, 2 B. T. A. 430	19
Manhattan Brew. Co., Appeal of, 6 B. T. A. 952	9-14-16-17-19
Milwaukee Brew. Co. v. Commissioner, 15 B. T. A. 579	9-14-17
Northern Hotel Co., Appeal of 2 B. T. A. 1099	15
National Industrial Alcohol Co., 38 Fed. (2nd) 718	17-18
Niagara Falls Brewing Company v. Commissioner 38 Fed. (2nd) 217	2-9
Otis Steel Co., Appeal of 6 B. T. A. 358-364	16
Renziehausen v. Commissioner, 31 Fed. (2nd) 675; 280 U. S. 387	9, 17
Redwing Malting Co. v. Willcutts, 15 Fed. (2nd) 626	9, 16
Star Brewing Co., Appeal of, 7 B. T. A. 377	9, 17
U. S. v. S. S. White Mnf. Co., 274 U. S. 398	18

Statutes and Regulations.

	PAGE
Judicial Code §240 (C. 229, 43 Stats. 938)	2
Revenue Act 1918, §234, A (7) (C. 18, 40 Stats. 1077)	2-3
Regulations 45, Articles 143, 161-2	8
Regulations 62, Articles 143, 161-2	9
Regulations 65, Articles 143, 161-2	9
Regulations 69, Articles 143, 161-2	9
Regulations 74, Articles 201-2	9
A. R. R. 963 1-1, C. B. 161	9
A. R. M. 34 2 C. B. 31	14
T. B. R. 441 C. B. August 1919—p. 133-7	14-17

IN THE

Supreme Court of the United States

OCTOBER TERM, 1930

No. 352

V. LOEWERS GAMBRINUS BREWERY CO.,
Petitioner,

against

CHARLES W. ANDERSON, individually and as collector of Internal Revenue of the United States,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR V. LOEWERS GAMBRINUS BREWERY CO., PETITIONER.

This case is before the Court on a writ of certiorari granted October 20th, 1930 (R. 214), and involves a suit brought by the respondent in the United States District Court for the Southern District of New York for the recovery of Federal income and profit taxes paid for the calendar years 1918 and 1919.

Opinions Below.

Circuit Court of Appeals for the Second Circuit, Opinion, 42 F. (2d) 216; (R. 211, 212).

The District Court rendered no opinion other than Findings of Fact and Conclusions of Law (R. 22) and the judgment (R. 34).

The judgment of the District Court was in favor of the plaintiff for the sum of $22,091.01 with interest and costs (R. 34). The Circuit Court of Appeals reversed the judgment of the District Court and directed the entry of judgment for the respondent (R. 213). Its mandate was subsequently amended by inserting a provision therein for judgment in favor of the petitioner in the sum of $1,126.85, it appearing that the petitioner's right to a judgment for at least that amount was not contested (R. 213).

Jurisdiction.

This Court has jurisdiction under Section 240 of the Judicial Code as amended by the Act of February 13, 1925 (c. 229, 43 Stats. 938; U. S. c. Title 28, Section 347). The petitioner prayed for the writ of certiorari upon the ground that a deduction from income on account of obsolescence of tangible assets had been uniformly allowed by the Courts of the United States and by the U. S. Board of Tax Appeals prior to the decision of the Circuit Court of Appeals in the instant case, and upon the further ground that the decision of the Circuit Court of Appeals resulted from a misinterpretation of the decision of this Court in *Clarke* v. *Haberle Crystal Springs Brewing Company*, 280 U. S. 384, and was in direct conflict with its decision in *Niagara Falls Brewing Company* v. *Commissioner of Internal Revenue*, 38 Fed. (2d) 217, in which certiorari had been granted by this Court.

Question Presented.

Is petitioner entitled to a deduction from its income for obsolescence of its brewery buildings, plant and equipment which became valueless with the advent of Pro-

hibition, under Section 234 (a) Subdivision 7 of the Revenue Act of 1918 (c. 18, 40 Stat. 1077) which allows corporations subject to tax in computing their net income to deduct "(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence" * * *?

The Statute Involved.

The Revenue Act of 1918, c. 18, 40 Stat. 1057-1077, provides in part as follows:

> "Section 234 (a). That in computing the net income of a corporation subject to the tax imposed by Section 230 there shall be allowed as deductions:
> * * * * * *
> (7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence * * *."

Statement of Case.

The findings of fact made by the Trial Court appear at pages 22 to 26 of the record. They are founded upon a stipulation of the parties (Plaintiff's Exhibit I; R. 170); upon admissions or concessions made during the course of the trial (R. 80-81); and upon a mass of uncontradicted evidence consisting of the testimony of Jacob Loewer, president of the corporation, an expert brewer; the testimony of an architect particularly qualified by long experience with brewery construction; a builder and engineer having like experience, and a consulting engineer formerly in the service of the United States. Their testimony was fortified by photographs and other evidence. The buildings were designed and constructed for brewery purposes only and their design and construction were such as to render them not only useless for other purposes, but also to make it impossible to salvage any part of them

for rebuilding purposes in the event of demolition. The equipment was of such character that it could not be removed without the destruction of the buildings themselves.

For the greater convenience of the Court the findings of fact are set forth at length. They are:

1. That at all the times hereinafter mentioned the plaintiff was and still is a corporation organized under the laws of the State of New York and having its principal place of business in the City of New York.

2. That the plaintiff on March 15, 1929 filed its tentative income and profits tax return for the calendar year 1918 and on June 5, 1919, within the extension of time allowed, filed its final income and profits tax return for the calendar year 1918, said final return showing an amount of tax due for said year in the sum of $1,339.13 and that said amount was paid to the defendant on the dates and in the amounts as follows:

March 24, 1919	$ 234.06
June 9, 1919	1,005.07
Total	$1,339.13

3. That during the year 1924 an additional assessment in the amount of $6,847.43 was levied against the plaintiff on account of income and profits taxes for the calendar year 1918. That the said amount was paid by the defendant crediting against such additional assessments the following sums which it had certified were over assessed:

For the year 1913	$ 60.00
For the year 1914	60.00
For the year 1915	60.00
For the year 1916	120.00
For the year 1917	1,055.16
For the year 1920	1,365.42
Total	$2,720.58

4. That said amount of $2,720.58 represented overpayments made by the plaintiff on account of income

and/or profits taxes for such years as indicated in the foregoing table; that the credit of said sums was duly authorized by the Commission of Internal Revenue and that after crediting said sum of $2,720.58 against said additional assessment there remained an amount unpaid on said additional assessment of $4,126.85; that said amount of $4,126.85 was paid by plaintiff under protest on June 13, 1924.

5. That the total income and profits taxes paid by the plaintiff on account of the year 1918 amounted to $8,186.56.

6. That thereafter the plaintiff duly filed claims for refund for the total amount of $8,186.56 paid by it as income and profits taxes for the calendar year 1918 and said claims for refund were based upon a claim of right to deduct from income additional amounts on account of allowances claimed for obsolescence in respect of brewery buildings and intangible property and that said claims for refund were rejected by the Commissioner of Internal Revenue. Plaintiff also duly filed an amended claim for refund upon the ground that collection of the additional amount paid on June 13th, 1924, was barred by the statute of limitations in such cases made and provided. No action has been taken by the Commissioner of Internal Revenue upon said amended claim and more than six months have elapsed since its filing.

7. That the net income and profits taxes for the calendar year 1918 assessed against plaintiff as aforesaid were based upon a net income of $56,832.02 determined by the Commissioner of Internal Revenue and that in arriving at such net income the Commissioner allowed no deduction whatsoever on account of obsolescence in respect to brewery buildings or intangible property.

8. That the plaintiff on March 11, 1920 filed its tentative income and profits tax return for the calendar year 1919, and on June 15, 1920, within the extension of time allowed, filed its final income and profits tax return for the calendar year 1919, said final return showing an amount of tax due for said year in the sum of $1,008.42 and that said amount was paid to the defendant on the dates and in the amounts as follows:

March 16, 1920	$252.90
June 29, 1920	756.32
Total	$1,008.42

9. That during the year 1924, an additional assessment of $10,171.41 was levied against the plaintiff on account of income and profits taxes for the calendar year 1919, that said amount was paid by plaintiff to defendant under protest on June 13, 1924.

10. That the total income and profits taxes paid by plaintiff on account of the year 1919 amounts to $11,179.83.

11. That on June 24, 1924, plaintiff duly filed claims for refund in the amount of $11,179.83 representing total income and profits taxes theretofore paid by the plaintiff for the calendar year 1919. That said claims for refund were based upon a claim of right to deduct from income additional amounts on account of allowances for obsolescence claimed in respect of brewery buildings and intangible property. That said claims for refund were rejected by the Commissioner of Internal Revenue.

12. That the income and profits taxes for the calendar year 1919 assessed against the plaintiff as aforesaid were based upon a net income of $74,838.77, as determined by the Commissioner of Internal Revenue; that in arriving at said net income the Commissioner allowed no deduction whatsoever on account of obsolescence in respect of brewery buildings or intangible property.

13. That the plaintiff since the year 1879 and until October 29, 1919, has been engaged in the business of manufacturing and selling beers, ales and porter for which purpose it erected buildings and installed the necessary machinery and equipment in the Borough of Manhattan, City of New York, and in which its operations were carried on at all the times involved in this action.

14. That on the 31st day of January, 1918, it had become a matter of common knowledge and was known to the plaintiff that prohibition would become the law of the land and that as a result of such law

persons engaged in the business of manufacturing and selling beers, ales and porter including this plaintiff would suffer obsolescence in the value of their capital assets, and such prohibition became effective January 16, 1920.

15. That at January 31, 1918, the depreciated cost of buildings used by the plaintiff in its manufacturing operations as found by the Commissioner of Internal Revenue was the sum of $153,932.18. That said buildings were constructed especially for the purposes of manufacturing, selling and delivering beers, ales and porter and were not commercially adaptable for any other use.

That at January 16, 1920, such buildings had no salvage value.

15. That as a result of prohibition and beginning January 31, 1918, and ending January 16, 1920, the plaintiff suffered obsolescence of said buildings equal to the total depreciated cost thereof, to wit: $153,932.18 which should be rateably apportioned over such period.

16. That the plaintiff had built up a valuable trade in the products which it manufactured. That such trade was of the value on March 1, 1913, and at January 31, 1918, of not less than $200,000. That as a result of prohibition the plaintiff suffered obsolescence in the value of its trade equal to the total thereof, to wit: not less than $200,000 which should be apportioned rateably over the obsolescence period, to wit: January 31, 1918, to January 16, 1920.

17. That after making provision for the allowances for obsolescence of either tangible or intangible property as set forth above the plaintiff had no net income for either of the years 1918 or 1919 and that all sums of money paid by it as and for income and excess profits taxes for such years were erroneously and illegally collected.

18. That the sum of $4,126.85 paid under protest by the plaintiff on June 13, 1924, on account of the additional assessment of taxes made by the Commissioner of Internal Revenue against it as and for the year 1918 as hereinbefore set forth was so paid more than five years after the filing of the plaintiff's return for such year.

It was stipulated or admitted at the trial that the depreciated cost of the buildings upon which obsolescence, if any, was to be allowed for 1918 and 1919 was $153,932.18 and that such allowance was properly spread in the findings (Appellant's Brief below, pp. 6 and 15).

ARGUMENT.

Under Section 234 (a) (7) of the Revenue Act of 1918, a brewing company was entitled to deduct from its income for the years 1918 and 1919 a reasonable allowance for exhaustion, wear and tear, including obsolescence, of its buildings and equipment, it having become certain prior to that time that their useful life would be terminated by January 16, 1920, because of prohibition legislation.

Legal Recognition of the Deduction.

The Statute provides that in computing the net income of a corporation subject to the tax imposed by Section 230, there shall be allowed as a deduction, "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." For a considerable period of time there was wide disagreement as to whether the statutory allowance covered intangible as well as tangible property. That question was set at rest by the decision of this Court in *Clarke* v. *Haberle Crystal Springs Brewing Company*, 280 U. S. 384. The application of the Statute to tangible property has never appeared to be in doubt until the decision of the Circuit Court of Appeals in the instant case, although the right to the deduction in specific cases may have been denied upon the merits.

Article 143, 161 and 162, Regulations 45 (1919)—
Revenue Act of 1918;

Article 143, 161 and 162, Regulations 62 (1922)—Revenue Act of 1921;
Article 143, 161 and 162, Regulations 65 (1924)—Revenue Act of 1924;
Article 143, 161 and 162, Regulations 69 (1926)—Revenue Act of 1926;
Article 201 and 202, Regulations 74 (1929)—Revenue Act of 1928;
A. R. R. 963, 1-1 C. B. 161;
Niagara Falls Brewing Co. v. *Comr.*, 38 Fed. (2d) 217, Certiorari granted;
Redwing Malting Co. v. *Willcutts*, 15 Fed. (2d) 626, Certiorari denied, 273 U. S. 763;
Appeal of Manhattan Brewing Co., 6 B. T. A. 952;
Appeal of Mary Dowling, 6 B. T. A. 976;
Appeal of Star Brewing Co., 7 B. T. A. 377;
Appeal of George Wiedemann Brewing Co., 9 B. T. A. 792;
Renziehausen v. *Commissioner*, 31 Fed. (2d) 675, Aff. 280 U. S. 387;
Milwaukee Brewing Co. v. *Comm.*, 15 B. T. A. 579;
Appeal of Konrad Schreier Co., 9 B. T. A. 407;
Appeal of Northern Hotel Co., 2 B. T. A. 1099.

The Theory of the Court Below.

After espousing a contrary view for many years, the Government contended in the instant case that the retention and use of the tangible property involved precluded the allowance of the deduction. It was not however upon this theory which it had just repudiated (*Niagara Falls Brewing Company* v. *Comm.*, *supra*) that the Circuit Court of Appeals reversed the judgment of the Trial Court, but because in its view the decision of this Court in *Clarke* v. *Haberle Crystal Springs Brewing Company* left it no alternative.

Haberle v. Crystal Springs Brewing Co. Distinguished.

We think the error of this view is manifest. In the Haberle case this Court was dealing with the question of whether under Subdivision (a) (7) of Section 234 of the Revenue Act of 1918, a brewing company is entitled to claim the obsolescence deduction in respect of its good will. True the language of this Court in the Haberle case was very broad, but when confined to the subject to which it was addressed, it does not justify the assumption that what was said was intended to apply to tangible as well as to intangible assets. In arriving at its conclusions in the Haberle case the Court was confronted with a statute that made no direct provision for obsolescence of good will. It declined to read such a provision into it, or to interpret the language found, to include it, deeming it plain that Congress could not have intended to afford compensation by abatement of taxes for the loss of good will of a business it had destroyed as noxious.

For the condemnation of the "business" regarded as noxious no compensation was provided and it seemed plain to this Court that Congress could not have intended to afford compensation in the form of abatement of taxes. Did that view not result, however, from the absence of any direct language in the subdivision granting such abatement? Suppose the statute had provided for "a reasonable allowance for exhaustion, wear and tear of assets used in the trade or business including good will" could, or would, this Court have disregarded its plain mandate? The answer, we think, is obvious. If therefore it be plain that in the absence of definite pronouncement to that effect, Congress could not be deemed to have intended an abatement of taxes for obsolescence of good will, it would appear to be equally plain, that in the absence of any exception in the Statute, the definite grant of the allowance in respect to tangible property, is available to all persons alike.

The refusal of this Court to read into the Statute, language that was absent, clearly does not justify the notion that it read into the Statute other language that was also absent.

The opinion below imputes to this Court, the promulgation of a remarkable doctrine. It is that either there is no deduction for obsolescence in any case, which this Court certainly did not say and we are sure could not have intended since the statute makes plain provision for it; or that, though the deduction is in terms accorded to *every* corporation subject to the tax, a company engaged in the brewing of beer is not entitled to it. This latter imputation is as little justified by the opinion of this Court, as the former. The deduction is in terms accorded to *every* corporation subject to the tax; there are no exceptions. The subdivision deals with income not with persons. It would seem, but for the decision below, inconceivable that such a construction could be placed upon the opinion in the Haberle case: the more so when we consider the results that would naturally follow.

A brewing company is either entitled to all the statutory deductions or to none of them. If it be not entitled to the obsolescence deduction, it is not entitled to the depreciation deduction, to the deduction for bad debts, to the deduction for losses by fire or other casualty, to the deduction for taxes or expenses of operation. There is no more justification for the withholding of the one than of any of the others. It would follow, therefore, that such a corporation must be taxable on gross income instead of net (as the statute provides) or not taxable at all. It seems unnecessary to prolong such an argument.

A proper reading of the opinion in the Haberle case, it seems to us, should have prevented such a result as has been reached below. This Court said * * * "In our opinion the words now used cannot be extended to cover the loss in *this* case and it is needless to speculate as to what other cases it might include."

In our view, this Court made it plain that cases might well arise where even a deduction for obsolescence of intangibles might be allowable. How, then, can it possibly be said that its decision precluded the allowance for obsolescence of tangible assets for which specific provision is made, when, in fact, the Court, confined itself strictly to the case before it and left open for the future, the determination of whether the deduction even for intangibles might not in some cases be allowable.

Much stress is laid upon the reference to the brewing business as "noxious." Here again, it seems to us, the Court below misconceived the application of the reference. If as this Court said, the "business" was regarded by Congress as noxious, which of course is true, did this Court say that it regarded buildings and automobiles and fixtures and machinery, inoffensive in themselves, as "noxious" also. We think not. If Congress had intended to deny to any corporation, the benefit of the deductions set forth in Section 234, we think this Court would insist upon a statutory expression to that effect, before it made so invidious a distinction. We feel justified therefore in asserting that this Court used the word noxious as applying to a "traffic" in liquor and not to the buildings in which a part of such "traffic" had its origin.

Assuming therefore that the Court below erred in extending the scope of the Haberle decision beyond the point there decided, we proceed to a discussion of the merits of the instant case.

The object of the Statute was to tax net income in a given period of time. To reach net income certain well recognized deductions from gross income are necessary. We are here dealing with one of the most common of these, the depreciation deduction, and its blood relative, the obsolescence deduction. The statutory history of the provision is interesting and enlightening.

Statutory History.

The Excise Tax Act of 1909 permitted the deduction of "a reasonable allowance for depreciation of property, if any" (Section 38, Paragraph 2). Regulations 31, Article 4 construed that deduction as covering obsolescence. The 1913 Act Limited the deduction somewhat by providing for "a reasonable allowance for depreciation by use, wear and tear of property, if any." Section G (b), Regulations 33, Article 192, continued to hold obsolescence an allowable element under this subdivision. The 1916 Act made a significant change in the provisions of the previous Act. The word "depreciation" was dropped and the deduction permitted was changed to a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the trade or business (Section 12a). This definitely excluded obsolescence and recognizing this, Regulations 33 (revised) Article 178, excluded obsolescence.

This was the history of this provision up to the time when Congress began consideration of the 1918 Act. The House in originating this Act wrote the provision for this deduction in the language contained in the 1916 and 1917 Acts, namely, an allowance for "exhaustion, wear and tear of property." The Senate Finance Committee proposed an amendment striking out the words "exhaustion, wear and tear" and substituting the word "depreciation." This was evidently to restore the status existing before the 1916 Act was passed, encompassed within the regulations of the department, holding obsolescence to be allowable under the term "depreciation." However, the proposed amendment went to conference and apparently for the purpose of making sure that there could be no doubt about the right to the obsolescence deduction, the conferees struck out the word "depreciation," reinserting the words "exhaustion, wear and tear," and adding the words "including a reasonable allowance for obsolescence."

That the purpose was to allow a set-up by way of an-

nual reserve to take care of a depreciation in the value of assets which could be anticipated with reasonable certainty in addition to the ordinary allowance for physical exhaustion is too apparent to permit of extended argument and the decisions of the Bureau, their regulations, the decisions of the U. S. Board of Tax Appeals and the Courts establish that this is so.

It is well settled that obsolescence may and does result from progress in an act, change of style and *legislation*. That the legislation encompassed within the 18th Amendment and the Volstead Act, created such a result cannot be denied. It has been recognized by the respondent and effect given to it in the Regulations.

Art 143, Reg. 45;
T. B. R. 44, 1 C. B. Aug. 1919, 133-7;
A. R. M. 34, 2 C. B. 31.

In the Appeal of Manhattan Brewing Co., supra it said:

> "Obsolescence is defined in Webster's New International Dictionary as 'state of becoming obsolete' and obsolete is defined as 'no longer in use'; 'neglected.' Obsolescence can be distinguished from 'wear and tear' in that wear and tear refers to the physical condition, while obsolescence refers to disuse and disappearing value arising from some extrinsic or external causes, such as progress in an art, change of style, or *legislation*. Machinery may be in good physical condition, but, by reason of change of style or progress in the art in which it is employed, be obsolete or in a state of obsolescence. It should be noted that obsolescence is defined as the state of *becoming obsolete, and does not necessarily imply that the disuse should be completed.*"
>
> *Milwaukee Brewing Co.* v. *Comm.*, 15 B. T. A. 579-82.

Theory of the Deduction.

The theory of the obsolescence deduction is that it should be sufficient together with a deduction for normal

depreciation, to return the unextinguished cost of the property less its salvage value at the end of the obsolescence period. We think the propriety of that statement will not be questioned.

Accountants, engineers, lawyers and business men appreciate that certain assets are of a depreciable character; that there is a progressive diminution in value. The accountant's theory which has been adopted by Congress is that this indefinite but nevertheless certain element must be taken care of by a reserve or deduction made annually so that the capital value will be returned at the end of an arbitrarily fixed period. Nobody would be stupid enough to say that at the end of the depreciation period the property, of necessity, has no value. Everyone knows that the contrary is more likely to be the fact. For example, an accountant might set a depreciation charge of five per cent annually. At the end of twenty years the total charges would reflect the total capital loss sustained but at no point between the beginning and the end of the twenty year period, except by merest accident, would such depreciation reflect the actual loss sustained up to that date. Nor would his depreciation coincide at any point with the amount of loss computed on the proportionate efficiency or saleable value. The efficiency of a machine which has been in use for a few months is often greater than that of a new one and at no time does its efficiency fall below seventy-five per cent, because below that point it is unserviceable. On the other hand, from the point of view of saleability, a machine drops from new to second hand value, a loss which may be over fifty per cent, after a few days' use. Thus, the depreciation allowance has not the slightest relation to an actual or sustained loss.

If then, we change the words "exhaustion, wear and tear" to "obsolescence," do we not have precisely the same situation? What is the result? The Government recognizes that it must have some reasonable system of account-

ing. It is by such a system of accounting that income is determined. In the illustration given, the deduction for exhaustion ceases the moment the capital value is returned and thereafter the taxpayer reports his income without deduction of that item. If he sells the property thereafter he reports as income the full sales price. It has been pointed out that the whole purpose of granting obsolescence was to prevent the necessity of waiting for complete loss and thus compelling the taxpayer to write off in one year a sum far in excess of the income against which it could be written off; in which latter event the taxpayer suffers not only the loss of his property, but also is denied a chance to write if off against income.

Obsolescence and Accelerated Depreciation.

Obsolescence has been defined by the Board of Tax Appeals as a state of becoming obsolete. That definition, while it may be said to be accurate, is not helpful. What is the *practical* meaning of the word? It has been insisted that as used in the Statute it is a word of enlargement of exhaustion, wear and tear (*Redwing Malting Company* v. *Willcutts*, 15 F. (2d) 626; *Appeal of the Manhattan Brewing Company*, supra). Viewed from that standpoint, it adds to the allowance for exhaustion or depreciation. If an asset is depreciable under normal conditions over a period of let us say ten years and some unusual economic upheaval occurs to hasten the normal end of the assets subject to depreciation, an additional allowance is proper, indeed necessary, to return capital value of the asset. The result is an acceleration of depreciation, such as granted in the case of buildings and machinery where the state of the art has changed.

The Board of Tax Appeals has held that no mathematical formula is to be used to the exclusion of facts. *Otis Steel Company*, 6 B. T. A. 358, 364. The inquiry in all cases is—over what period of time in the particular case is the captial value to be returned?

The Obsolescence Period.

The Bureau of Internal Revenue, recognizing that the 18th Amendment created an economic upheaval in relation to assets used in a trade or business subject to its condemnation, justifying a claim for obsolescence in addition to normal depreciation fixed the period over which the deduction therefor was to be taken as beginning January 31, 1918, and ending January 16, 1920.

T. B. R. 44, 1 C. B. August 1919, 133-7 A. R. M. 34 2 C. B. 31;
Haberle v. Crystal Springs Brewing Co., 30 Fed. (2nd) 219;
Appeal of Manhattan Brewing Co., 6 B. T. A. 952;
Milwaukee Brewing Co. v. Comm., 15 B. T. A. 579-82.

In line with this, it is admitted that the deduction in the instant case, if allowable, has been properly spread through the period prescribed by the Bureau.

Decisions Reviewed.

The right to the deduction appears to have been uniformly recognized.

National Ind. Alcohol Co. v. Commissioner, 38 Fed. (2d) 718, Certiorari granted;
Appeal of Manhattan Brewing Co., 6 B. T. A. 952;
Appeal of Mary Dowling, 6 B. T. A. 976;
Appeal of Star Brewing Co., 7 B. T. A. 377;
Appeal of George Wiedemann Brewing Co., 9 B. T. A. 792;
Renziehausen v. Commissioner, 31 Fed. (2d) 675. Affirmed 280 U. S. 387;
Appeal of J. Christian G. Hupfel, 9 B. T. A. 944.

In *Renziehausen v. Commissioner*, supra, a deduction was allowed for obsolescence on storage warehouses due

to Prohibition. This allowance was affirmed in the Circuit Court of Appeals and in this Court.

In that case the Board had held that obsolescence began as to warehouses used and usable only for the storage of whiskey when the Willis Campbell Act was passed on November 23, 1921. The Government urged that the taking of the loss should be postponed to a time when all whiskey should have been removed from the warehouse. The Board held that the deduction should be spread over the year 1921 and subsequent years as the removal took place. It held that the distillery itself became obsolete in that year and that the loss from that source was deductible. It thus decided that where the loss was final in the case of obsoleteness it should be taken off in the year in which the assets became obsolete and spread over a period of years as to assets continued in use. Thus the Board recognizes the Subdivision of Section 234 applying to losses sustained in trade and also the Subdivision providing for a reasonable allowance for obsolescence.

In *National Industrial Alcohol Co.* v. *Commissioner*, 38 Fed. (2d) 718, it appeared that in November of 1919 the appellant abandoned the manufacture of beer and the use of its trade-name and entered upon the business of manufacturing near beer. It subsequently began the manufacture and sale of industrial alcohol and in 1923 discontinued the near beer business. The plaintiff claimed that it had abandoned two floors which had no residual or salvage value. The Circuit Court of Appeals held that this contention was amply sustained, it appearing that the building was unsuitable for any other purpose and that the only use made after the abandonment of the brewing of beer was of the first floor for the manufacture of cereal beverages. The Court said,—"A loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. * * * The Taxing Act does not require the taxpayer to be an incorrigible optimist," citing *U. S.* v. *S. S.*

White Mfg. Co., 274 U. S. 398. The distinction between that case and others is of course that the abandonment was actually claimed by the taxpayer and the allowance by the Circuit Court of Appeals was of the loss sustained and not of a claim for obsolescence.

The leading case decided by the United States Board of Tax Appeals is that of the *Appeal of the Manhattan Brewing Co.*, 6 B. T. A. 952. In that case, which was almost identical with this, an obsolescence deduction for the year 1918 of $255,488.56 was allowed on the tangible assets. The Board said "Obsolescence is recognized by Statute. • • • It remains, then, for us to determine whether the amount so written off and deducted comes within the requirements of reasonableness as set forth in the law. There is no question as to the value of the property. The period of obsolescence extending from December 18, 1917, to January 16, 1920, is equally well established. Prohibition at an early date was almost a certainty. We are convinced that the amount of $255,488.56, determined by the petitioner, was a reasonable measure of the obsolescence of its tangible property during the year 1918. (*Appeals of Michigan Lithographing Co.*, 1 B. T. A. 989, *Robert H. McCormick*, 2 B. T. A. 430, *Auditorium Co.* v. *Commissioner*, 5 B. T. A. 163.)

In *Appeal of George Wiedemann Brewing Co.*, supra, the Board considered a claim concerning the obsolescence of tangible assets rendered useless by prohibition. There, as here, the depreciated cost according to the books was accepted by the respondent and therefrom he deducted the amount of the salvage value estimated by the petitioner, considering the remainder the amount of loss due to obsolescence. The petitioner concluded that its estimate of salvage value grossly overstated the truth and asked for an increase in the allowance. The Board sustained the petitioner and increased the allowance in accordance with its contention. The parties differed as to the proper method of pro-rating, the Commissioner contending that

the proper period for the spread was January, 1918, to January, 1920. The petitioner claimed it as a loss in 1919. The Board held that the obsolescence period actually set in in January, 1918, that the assets had suffered special obsolescence through 1918 to the beginning of the fiscal year 1919. It limited the period therefore to the date in 1919 when brewing was discontinued.

In the *Appeal of J. Christian G. Hupfel Co.*, supra, the Board allowed obsolescence of buildings, taking the obsolescence period as the date when it began liquidation to the date when the obsolescence period ended, to wit, January 16th, 1920. In that case, petitioner had determined to liquidate its business. Its buildings originally erected as brewery units, contained many features which precluded their adaptation to other commercial uses without considerable demolition and reconstruction. It continued to use the buildings long after the end of the obsolescence period and did not start reconstruction until 1921. The Board held that the continued use of the buildings after the period of obsolescence had run, did not militate against the allowance of an obsolescence deduction therefor. In that case it is to be noted it was conceded that the taxpayer was entitled to an allowance for obsolescence of its equipment. If in the Hupfel case the taxpayer was entitled to its claim for obsolescence, there can be no gainsaying the right of this petitioner to the same relief. This petitioner is in a far stronger position. None of its buildings involved here are adaptable to other commercial uses even by alteration. Their value is nil.

The Deduction in Relation to the Taxable Period.

A unit of time (a year) is an essential factor in statutory taxable net income. That factor makes a vast difference in many ways. Without it we may study net income ad infinitum either as an abstraction or as an actuality and we will make only partial progress toward the

determination of the statutory taxable net income. As a matter of fact, there is little, if any, relationship between the amounts of net-income, per se, and Net-Income-in-a-Unit-of-Time.

To determine Net Income in a given unit of time we are to deduct a reasonable allowance for the exhaustion, wear, tear and obsolescence of property. Any "reasonable allowance" is initially a philosophical and not a mathematical study. Whether the deduction be for the tax-free return of a capital investment over the period of its useful life or be the measure of asset consumption by business operation is not here to be argued.

For the finding of net income, per se, the deduction is of little difficulty. The value of all capital investment is left whole, at the end as at the beginning. The difficulty begins when the essential factor of the Unit-of-Time comes into play and we must determine not merely net income but net-income-in-a-unit-of-time.

The method currently favored for computing this deduction for a unit of time is, quite naturally the simplest one, that of pure mathematics. Divide the capital investment by the years of its life and allocate the quotient to each year. This is so-called "straight line" method, the product of accounting thought and supported by accounting practice. But (and here we approach the nub of this controversy), the statute says nothing about the straight line method or any other method for computing the deduction. Nor is there any philosophical basis for confining the deduction for a given unit of time to a mathematical proportion of the total investment to be returned. The term "reasonable" is exclusive only of that which is unreasonable, and the straight line method does not, and cannot be claimed to, yield the sole reasonable result. In fact, its only claim to reasonableness is its simplicity and its eventual completeness. It has a philosophical excuse only through ignoring the unit-of-time factor and computing net income per se for the entire transaction or opera-

tion, maybe decades in duration. It results in a deduction for a given unit of time which is of very questionable reasonableness. Its premise is that exhaustion, wear, tear and obsolescence of an asset is equal for every equal unit of time. As a matter of actual fact, the wear and tear on a given machine, for example, for a given year has no real relationship to the wear and tear for the next year or the prior year or the tenth year therefrom. Only if the causes of wear and tear, such as hours of use, suitability to use, skill of operation, persistence of upkeep, expertness of repair, weather and many other elements, be the same in two different years, is the wear and tear the same. Only by accident does the result of the straight line method coincide with the truth in determining this deduction for net-income-in-a-unit-of time. It would be exactly as reasonable to compute gross income over the term of business operation and divide by the number of years to find the gross income for a given year. There is no distinction; neither is more reasonable than the other.

The proposition that this deduction is to return tax-free the capital investment means, of course, a return of equivalent values and not a return of identical substance. The taxpayer is to have at the end of the life of his building a value, in money or reinvestment, equivalent to the initial value of his building.

Deduction Has No Relation to Physical Substance.

Note that as applied to physical assets, one-half of the clause providing this deduction relates to physical substance and the other half relates solely to value. Exhaustion, wear and tear of physical assets is physical deterioration, dissipation or consumption. But obsolescence has no bearing upon the physical existence or condition of the asset. Obsolescence is the destruction of value by the impact of economic factors, and its complete annihilation of asset-value may leave the asset-substance unchanged. A machine totally superseded by a newer, better machine

and of no value save as junk, may nevertheless be in a state of physical perfection. The deductible allowance is to permit to the taxpayer tax free a *value* equivalent to the total original capital investment in the machine.

In the instant case it has been determined that within the years 1918 and 1919 economic forces, which petitioner names and describes, destroyed a certain value of its assets, the amount of which has been adjudged. Its net income for those years cannot be accurately fixed unless it has returned to it tax free at the end of each unit of time a value equivalent to the initial value of its asset.

If the taxpayer be not made whole at the end of that unit of time, the allowance has not performed its function and net income for that time has been to that extent distorted. If the problem under the statute were to determine the net income for the full life of the assets or for a business operation or a specific transaction, the particular problem here involved might not arise. But the statute introduces into the general problem the vastly important element of one year as a unit of time by which the whole study is limited and controlled. The facts as to that particular year are the pertinent facts and the only pertinent facts to be considered.

To deny petitioner's contention is not only to distort net income for the current year but for all subsequent years until the physical lives of the assets expire. Unless this destruction of value be made good presently it must be later. So to do puts on the later years the burden of returning tax free to the petitioner from their incomes a capital investment already long since destroyed; it creates a hiatus during which the petitioner is without his full initial capital investment value; it shifts to a later year a proper charge against a former; it is as improper as the shifting of an expense or a bad debt from the year of its occurrence to a later year.

This controversy really reduces itself to the question whether, as we contend, the petitioner is entitled to have

tax free at the end of each taxable unit of time a value equivalent of its initial capital investment.

It is of course clearly true that in a vast majority of cases it is impossible or impractical to determine just what portion of its initial capital investment value remains to the petitioner in the original substance and, therefore, to determine exactly the value to which the petitioner is entitled tax free out of gross income. But that is a difficulty of practice and not of principle and is not present here.

These views we contend are sound. The judgment of the Trial Court sustains them and that judgment would have been affirmed by the Circuit Court of Appeals but for its conception of the views of this Court in Haberle v. Crystal Springs Brewing Company. Unless this Court holds that the right to the deduction is to be denied to a particular class, the judgment of the Trial Court was right and should be affirmed.

Respectfully submitted,

ARTHUR B. HYMAN,
KARL D. LOOS,
Attorneys for
V. Loewers Gambrinius Brewing Company,
Petitioner.